DEPARTMENT OF STATE REVENUE
LETTER OF FINDINGS: 02-0026
Indiana Corporate Income Tax
For the Tax Years 1997, 1998, and 1999

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ISSUES

I. Disallowance of Claimed Business Expenses – Adjusted Gross Income Tax.

Authority: IC 6-3-2-2; IC 6-3-2-2(l); IC 6-3-2-2(m); Gregory v. Helvering 293 U.S. 465 (1935); Lee v. Commissioner of Internal Revenue, 155 F.2d 584 (2d Cir. 1998); Horn v. Commissioner of Internal Revenue, 968 F.2d 1229 (D.C. Cir. 1992); Commissioner v. Transp. Trading and Terminal Corp., 176 F.2d 570 (2nd Cir. 1949); Bethlehem Steel Corp. v. Ind. Dept. of State Revenue, 597 N.E.2d 1327 (Ind. Tax Ct. 1992); 45 IAC 3.1-1-55.

Taxpayer argues that the audit, in calculating its adjusted gross income for 1998 and 1999, erroneously disallowed – as business expenses – royalty payments paid to a related entity for the right to use certain intellectual property.

II. Abatement of the Ten-Percent Negligence Penalty.

Authority: IC 6-8.1-10-2.1; IC 6-8.1-10-2.1(d); 45 IAC 15-11-2(b); 45 IAC 15-11-2(c).

Taxpayer urges the Department to exercise its discretion and abate the ten-percent negligence penalty assessed at the time of the original audit. Taxpayer argues that any tax deficiencies were not attributable to its negligence.

STATEMENT OF FACTS

Taxpayer is an out-of-state entity in the business of providing computer services. Taxpayer provides those services to customers inside the state, outside the state, and at locations throughout the world. Taxpayer's services include: client/server design and development; conversion/migration services; and applications maintenance outsourcing.

The Department conducted an audit of taxpayer's financial records spanning the 1997, 1998, and 1999 tax years. As a result of that audit examination, a number of adjustments were made which served to increase taxpayer's tax liabilities. Taxpayer disagreed with certain of those adjustments and submitted a protest to the Department of Revenue (Department). Pursuant to that protest, an administrative hearing was conducted during which taxpayer was provided an opportunity to substantiate the basis for its protest. As a result of that hearing, this Letter of Findings was prepared.

DISCUSSION

I. Disallowance of Claimed Business Expenses – Adjusted Gross Income Tax.

In 1998, taxpayer formed a Delaware holding company. The Delaware entity was created in order to hold certain items of taxpayer's intellectual property. The intellectual property consisted of a registered service mark and certain specialized methodologies collectively identified under a particular trade name. Before the intellectual property was transferred to the Delaware holding company, taxpayer hired an outside consultant to evaluate the intellectual property. The consultant assessed the relative value of the intellectual property and determined a method by which the affiliated companies would pay for the right to make continued use of the intellectual property. The consultant concluded that the affiliated companies should pay a royalty fee of four percent of their net income in order to employ the registered service mark. In addition, the consultant determined that the affiliated companies should pay for the continued use of the "specialized methodologies" based upon the amount of the customer's computer code processed using those methodologies. Taxpayer agreed with the consultant's conclusions and apparently adopted the suggested payment scheme.

Thereafter, taxpayer transferred ownership of the intellectual property to the Delaware holding company in exchange for a 100 percent ownership in that holding company. Taxpayer proceeded to make royalty payments to the Delaware holding company and – in calculating its own adjusted gross income derived from providing services within the state – claimed those payments as deductible business expenses. After receiving the royalty payments, the Delaware holding company retained a portion of the payments to cover its own operating costs. Thereafter, the Delaware holding company contributed the remaining funds to a wholly owned subsidiary which acted as an "investment vehicle" for the company. This wholly owned subsidiary used the royalty payments to maintain a portfolio of investments including commercial paper and municipal bonds. According to taxpayer, this arrangement "served to segregate the company's intellectual property from the investment capital and other intangible assets.

The audit disallowed the royalty payments as business expenses. It did so on the ground that the Delaware holding company was "not a viable business enterprise" and that the royalty payments constituted an "arbitrary shift of income." In support of its decision, the audit found that the Delaware holding company had no business activity, had no employees, had no assets, performed no function, assumed no risk, did nothing to earn the income, and that the "valuable" service mark was discarded less than two years after the holding company was first formed.

Taxpayer does not contest the factual basis for the audit's conclusions; it does contest the conclusions. Taxpayer does so on two grounds. Taxpayer maintains that the audit, under IC 6-3-2-2, did not have a legal or factual basis for forcing a combination of taxpayer and the Delaware holding company. In addition, taxpayer argues that the transfer of the intellectual property – and the consequent royalty payments – served a legitimate business purpose thereby transforming the royalty payments into deductible business expenses.

Taxpayer argues that the audit did not have the statutory authority to disallow the royalty payments because the Delaware holding company's royalty income was not Indiana source income. To that end, taxpayer cites to IC 6-3-2-2(m) which reads as follows:

> In the case of two (2) or more organizations, trades, or businesses owned or controlled directly or indirectly by the same interests, the department shall distribute, apportion, or allocate the income derived from sources *within the state of Indiana* between and among those organizations, trades, or businesses in order to fairly reflect and report the income derived from sources *within the state of Indiana* by various taxpayers. (*Emphasis added*).

In order for Indiana to tax the income derived from an intangible, the intangible – such as taxpayer's intellectual property – must have acquired a "business situs" within the state. 45 IAC 3.1-1-55 reads in part as follows:

> The situs of intangible personal property is the commercial domicile of the taxpayer . . . unless the property has acquired a "business situs" elsewhere. "Business situs" is the place at which intangible personal property is employed as capital; or the place where the property is located if possession and control of the property is localized in connection with a trade or business so that substantial use or value attaches to the property.

It is apparent that the Delaware holding company's intellectual property acquired a "business situs" within Indiana. The Delaware holding company licensed the taxpayer to use and exploit the intellectual property; the taxpayer obtained Indiana source income by providing its services within the state; the value obtained from possessing and exploiting the intellectual property was inextricably linked with the provision of taxpayer's services within the state. The value the Delware holding company obtained from the intellectual property was – in relevant part – its ability to license taxpayer to use and exploit the property within Indiana. The value of the intellectual property to the Delware holding company consisted solely of the ability to "place" that intellectual property within the state and to derive the consequent economic benefits attributable entirely to the taxpayer's Indiana business activities. As the regulation itself states, "'Business situs' is the place at which [the] intangible personal property is employed as capital . . . ." 45 IAC 3.1-1-55. The place at which "value attaches to the [intellectual] property" is within the state of Indiana. Id.

So far as relevant, IC 6-3-2-2(l), reads as follows:

> If the allocation and apportionment provisions of this article do not fairly reflect the taxpayer's income derived from sources within the state of Indiana, the taxpayer may

> petition for or the department may require, in respect to all or any part of the taxpayer's business activity, if reasonable:
>
> > (1) separate accounting;
> >
> > (2) the exclusion of any one (1) or more of the factors;
> >
> > (3) the inclusion of one (1) or more additional factors which will fairly represent the taxpayer's income derived from sources within the state of Indiana; or
> >
> > (4) the employment of any other method to effectuate an equitable allocation and apportionment of the taxpayer's income.

The audit disallowed the royalty payments because it determined that the payments were not "business expenses" but arbitrary shifts of income lacking any economic substance. It is not disputed that the Delware holding company has done nothing substantive to "earn" these royalty payments. It has performed no activities which protect or enhance the value of the intellectual property. Indeed, because the Delaware holding company apparently has no employees or physical location, it does not seem capable of performing any such activity. The record does not reveal how much of the $25,000,000 in royalty payments the Delaware holding company retained to pay its own expenses. The record does not reveal how the amount of royalty payments was transferred to the wholly owned "investment vehicle." However, the record *does* reveal that the Delaware holding company "has no assets." Therefore, because taxpayer acquired 100 percent ownership of the Delware holding company, it would appear that taxpayer retained the right to control the ultimate disposition of those substantial assets. Plainly speaking, it would appear that the royalty payments were simply the transfer of assets from one corporate pocket into another. Simply labeling the transfer as "royalty payments" and "business expenses," does not – in fact or law – make them so.

The audit was clearly justified in determining that permitting the taxpayer to classify the royalty payments as business expenses artificially distorted taxpayer's Indiana income. The plain language of IC 6-3-2-2(l) states that "[i]f the allocation and apportionment provisions of this article do not fairly represent that taxpayer's income derived from sources within the state of Indiana . . . the department may require, in respect *to all or any part of the taxpayer's business activity* . . . the employment of any other method to effectuate an equitable allocation and apportionment of the taxpayer's income." (*Emphasis added*).

In addition, the audit is justified in disallowing the royalty and interest deductions on the ground that the expenses were incurred as a result of a "sham transaction."

The "sham transaction" doctrine is well established both in state and federal tax jurisprudence dating back to Gregory v. Helvering 293 U.S. 465 (1935). In that case, the Court held that in order to qualify for a favorable tax treatment, a corporate reorganization must be motivated by the furtherance of a legitimate corporate business purpose. Id at 469. A corporate business activity undertaken merely for the purpose of avoiding taxes was without substance and "[t]o hold otherwise would be to exalt artifice above reality and to deprive the statutory provision in

question of all serious purpose." Id at 470. The courts have subsequently held that "in construing words of a tax statute which describe [any] commercial transactions [the court is] to understand them to refer to transactions entered upon for commercial or industrial purposes and not to include transactions entered upon for no other motive but to escape taxation." Commissioner v. Transp. Trading and Terminal Corp., 176 F.2d 570, 572 (2nd Cir. 1949), *cert denied*, 338 U.S. 955 (1950). "[t]ransactions that are invalidated by the [sham transaction] doctrine are those motivated by nothing other than the taxpayer's desire to secure the attached tax benefit" but are devoid of any economic substance. Horn v. Commissioner of Internal Revenue, 968 F.2d 1229, 1236-37 (D.C. Cir. 1992). In determining whether a business transaction was an economic sham, two factors can be considered; "(1) did the transaction have a reasonable prospect, *ex ante*, for economic gain (profit), and (2) was the transaction undertaken for a business purpose other than the tax benefits?" Id. at 1337.

Taxpayer maintains that the transfer of its intellectual property to the Delaware holding company was made for a legitimate business purpose. Taxpayer argues that the royalty payments were made in furtherance of that business purpose, that the payments were made at arms length, and that the value of the intellectual property – and the consequent payments to the Delaware holding company – was determined by an independent third-party.

There is no evidence that taxpayer's business operations changed after the intellectual property was transferred to the Delaware holding company. There is no evidence that the Delaware holding company performed any of the work necessary to preserve or enhance the value of the intellectual property. There is no evidence that the Delaware holding company incurred any independent expenses to manage, preserve, or enhance the value of the intellectual property. There is no evidence that the Delaware holding company ever exercised any independent authority over "its" intellectual property or that it ever had the actual authority to do so. There is no evidence that the Delaware holding company exercised any independent business judgment in an effort to more fully exploit the value of the intellectual property. There is no evidence that the transactions entered into between taxpayer and the Delaware holding company in any way added to the value of the intellectual property.

The question of whether or not a transaction is a sham, for purposes of the doctrine, is primarily a factual one. Lee v. Commissioner of Internal Revenue, 155 F.2d 584, 586 (2d Cir. 1998). The taxpayer has the burden of demonstrating that the subject transaction was entered into for a legitimate business purpose. IC 6-8.1-5-1(b).

The taxpayer has failed to meet its burden of demonstrating that the transfer of the intellectual property to the Delaware holding company or that the royalty payments subsequently made were supported by any business purpose other than tax avoidance. Taxpayer's tender of royalty payments was entirely illusory; any value the Delaware holding company received from the royalty payments accrued exclusively to the benefit of taxpayer because the Delaware holding company was entirely owned by taxpayer.

Taxpayer is, of course, entitled to structure its business affairs in any manner it deems appropriate and to vigorously pursue any tax advantage attendant upon the management of those affairs. However, in determining the nature of a business transaction and the resultant tax

consequences, the Department is required to look at "the substance rather than the form of the transaction." Bethlehem Steel Corp. v. Ind. Dept. of State Revenue, 597 N.E.2d 1327, 1331 (Ind. Tax Ct. 1992).

FINDING

Taxpayer's protest is respectfully denied.

II. Abatement of the Ten-Percent Negligence Penalty.

Taxpayer maintains that its tax deficiencies were not due to negligence and that it exercised reasonable care in respect to the duties placed upon it by the Indiana code and Department regulations.

IC 6-8.1-10-2.1 requires that a ten-percent penalty be imposed if the tax deficiency results from the taxpayer's negligence. Departmental regulation 45 IAC 15-11-2(b) defines negligence as "the failure to use such reasonable care, caution, or diligence as would be expected of an ordinary reasonable taxpayer." Negligence is to "be determined on a case-by-case basis according to the facts and circumstances of each taxpayer." Id.

IC 6-8.1-10-2.1(d) allows the Department to waive the penalty upon a showing that the failure to pay the deficiency was based on "reasonable cause and not due to willful neglect." Departmental regulation 45 IAC 15-11-2(c) requires that in order to establish "reasonable cause," the taxpayer must demonstrate that it "exercised ordinary business care and prudence in carrying out or failing to carry out a duty giving rise to the penalty imposed . . ."

The audit assessed the negligence penalty on the ground that taxpayer had substantially underreported its tax liability for 1997, 1998, and 1999. Nearly all of the additional assessments for 1997 and 1998 arose from taxpayer's failure to report Indiana income for gross income tax purposes. The audit found that, for gross income tax purposes, the income "[was] clearly reportable."

Even setting aside the validity of the adjusted gross income tax argument raised in part I of this Letter of Findings, taxpayer has failed to demonstrate that the underreporting of its gross income tax liability – almost 70 percent for 1997 – was a justifiable exercise in "ordinary business care and prudence." 45 IAC 15-11-2(c). To the contrary, taxpayer's underreporting clearly seems to be a "failure to use such reasonable care, caution, or diligence as would be expected of an ordinary reasonable taxpayer." 45 IAC 15-11-2(b).

FINDING

Taxpayer's protest is respectfully denied.